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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1942

No. 846

MAGNUS BECK BREWING COMPANY, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT AND BRIEF IN SUPPORT THEREOF.

FRANK D. SCOTT,
CHARLES J. WICK,
Counsel for Petitioner.

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MAGNUS BECK BREWING COMPANY, INC.,
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vs.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

The petitioner, Magnus Beck Brewing Company, Inc., by its attorneys, Garono, Jaeckle & Kelly, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Second Circuit in the above cause reversing the decision of the Tax Court and reinstating assessment against petitioner.

Opinions Below.

The Tax Court promulgated an opinion on January 14, 1942, reported in 46 B. T. A. 78. The Court below rendered an opinion on December 7, 1942, reported in 132 F. (2d) 379 (R. 44).

Jurisdiction.

The judgment of the Court below was entered on December 30, 1942 (R. 47). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Question Presented.

Where a taxpayer corporation threatened with bankruptcy enters into a written contract with the trustee for its creditors requiring said taxpayer to pay to such trustee a stated amount upon the sale of each unit of its sole product and commodity sold by it during each week, is the contract so entered into one which "expressly deals with the disposition of earnings and profits of the taxable year" within the meaning of Section 26 (c) (2) of the Revenue Act of 1936?

Statutes and Regulations Involved.

The Statutes and Regulations involved are set out in the Appendix, infra, pp. 8-11.

Statement.

The taxpayer is a corporation organized in 1932 under the laws of the State of New York and engaged in the brewing industry. By January, 1934, it had become financially involved, being unable to meet its obligations as they matured (R. 23). The solution to this situation took the form of a trust agreement wherein the taxpayer promised to pay each week to a trustee $1 "upon each barrel of beer sold by it" during the previous week. The trustee in turn was required to use this fund to pay the creditors in accordance with an agreed plan of priorities (R. 10-17, 24). The per-

tinent provisions of this trust agreement are as follows (R. 24):

> Third: The Corporation specifically agrees to pay to the Trustee, beginning April first, 1934, and until the expiration of this agreement, a stated amount upon each barrel of beer sold by it as hereinafter set forth, such payments to be made on or before Wednesday of each week for all beer sold by it during the previous Calendar Week, the first of such payments to be made on or before Wednesday, April 11, 1934; the rate per barrel to be paid by the Corporation to the Trustee shall be as follows:
>
> Fifty cents (50¢) per barrel, on all beer sold during the months of April and May, 1934, and One Dollar ($1.00) per barrel on all beer sold thereafter.
>
> Fourth: It is mutually understood and agreed that the Trustee shall have the right to waive any such weekly payment required to be made to him by the Corporation if he shall deem such waiver expedient and necessary, but any such waiver shall in no wise operate as a waiver of any other or further payment required to be made by the Corporation to said Trustee.
>
> * * * * * * *

The amount of $1 per barrel to be paid under the terms of the trust agreement was fixed by the trustee and accountants for the taxpayer after going over the sales of taxpayer for the month prior to the execution of the contract as an estimate of the profit taxpayer would make on each barrel produced and sold, if business conditions were prosperous (R. 25).

The following weekly payments were made to the trustee by the taxpayer in 1934, 1935 and 1936 (R. 25):

	1934		1935		1936	
	Payments to trustee	Barrels sold	Payments to trustee	Barrels sold	Payments to trustee	Barrels sold
January		2,063.50	$1,669.19	3,348.00	$1,870.00	3,508.00
February		1,729.00	1,605.20	3,360.25	1,981.50	3,514.50
March		2,559.00	1,863.62	4,442.75	1,893.00	4,276.75
April	$1,231.25	2,947.00	2,487.36	4,423.75	3,593.50	4,377.00
May	2,535.99	4,004.75	2,130.12	4,762.50	4,776.00	5,590.75
June	4,341.87	5,140.75	4,860.50	5,456.00	6,997.00	6,291.50
July	6,909.00	5,811.00	7,244.50	6,737.75	6,893.00	7,496.25
August	5,134.39	5,955.75	7,438.75	6,794.50	8,254.00	7,334.50
September	4,217.29	3,959.00	4,877.00	4,649.50	6,003.00	6,132.25
October	3,909.76	4,073.75	4,343.25	4,825.25	5,071.98	5,766.75
November	1,838.92	3,922.75	4,426.00	4,696.25	.....	4,973.25
December	659.35	3,867.00	5,626.00	4,149.75	.....	5,485.25
Total	30,777.82	46,033.25	48,571.49	57,646.25	47,332.98	64,746.75

The business of the taxpayer was seasonal and during the last two months of 1936, which was its off season, it was allowed by the trustee to reduce "payment to what we were able to pay." The taxpayer had an oral understanding with the trustee that it should pay its indebtedness from earnings. By virtue of the payments on account of beer produced and sold from 1934, the indebtedness secured by the trust agreement was completely paid off during 1937 and the assets of the company were thereafter free of these liabilities (R. 25).

The annual profits of the taxpayer, together with the barrels of beer sold and profits per barrel, upon an annual basis from 1933 to and including 1939, were as follows (R. 25-26):

	Profits for year	Barrels sold	Profit per barrel
1933	$2,052.05	13,014.25	$0.16
1934 loss	6,805.46	46,033.25	.15
1935	50,608.31	57,646.25	.88
1936	60,415.96	64,746.75	.93
1937	47,149.29	74,148.75	.63
1938	17,246.93	70,674.50	.24
1939	2,621.53	70,018.75	.04

In computing the surtax on undistributed profits imposed by the Revenue Act of 1936, the taxpayer claimed a credit under Section 26 (c) (2) of $47,332.98, being the total payment made to the trustee in that year. The Commissioner of Internal Revenue determined that this credit

should not be allowed and proposed to assess the resulting tax deficiency (R. 26). The Board of Tax Appeals held, however, that the taxpayer was entitled to the credit claimed and that the proposed deficiency was erroneous to the extent that such credit had not been allowed (R. 27). A small deficiency was entered against the taxpayer upon uncontested issues (R. 28).

Specification of Errors to Be Urged.

The Circuit Court of Appeals erred:

1. In holding that Section 26 (c) (2) should not be construed according to its underlying purposes, viz, the intent of Congress to grant a credit to corporations for moneys paid during the taxable year under written contracts which prevented accumulations of earnings and profits.

2. In holding that the Court must look to the written contract alone and disregard the financial situation of the taxpayer at time contract was made and at time of performance as the basis for credits allowed by Section 26 (c) (2).

3. In holding that the Commissioner is not obliged to examine the taxpayer's business and decide how much of what the contract calls for taxpayer could not avoid paying out of current earning and profits.

4. In holding that the taxpayer could have paid its obligations under its contract from any source other than its earnings on the sale of its sole product.

5. In holding that the situations in *Helvering* v. *Moloney Electric Co.*, 120 F. (2d) 617 (8th C. C. A.); *C. C. Clark, Inc.* v. *The United States*, 126 F. (2d) 292 (5th C. C. A.); *Helvering* v. *North West Steel Rolling Mills*, 311 U. S. 46; and *Nevada-Massachusetts Co.* v. *Commissioner*, 128 F. (2d) 347 (9th C. C. A.), were analogous to the case at bar and controlling.

6. In holding that *Commissioner* v. *Michigan Silica Company,* 124 F. (2d) 397 (6th C. C. A.), and *Clover Splint Coal Co.* v. *Commissioner,* 130 F. (2d) 52 (3 C. C. A.), were to be disregarded since payments therein were "flat within" the Treasury Regulations 94.

7. In reversing the Tax Court which held that since all payments made by taxpayer under its contract in question had to come from receipts of sale of beer (it had no other available funds) they necessarily included "earnings and profits of the taxable year" if there were any and that this satisfied Section 26 (c) (2).

Reasons for Granting the Writ.

As recognized by the Circuit Court of Appeals, the contentions of taxpayer were successful in the Second and Third Circuits. *Commissioner* v. *Michigan Silica Company,* 124 Fed. (2d) 397 (C. C. A. 6) and *Clover Splint Coal Co.* v. *Commisioner,* 130 Fed. (2d) 52 (C. C. A. 3). However, the Second Circuit in its opinion dismissed the conclusions reached in said cases with the statement that the payments for each ton of sand sold in the Michigan Silica case and for each ton of coal mined in the Clover Splint Coal Co. case were "flatly within Article 26-2 (c) (3) of Treasury Regulation 94".

The Circuit Court cited in support of its findings *Helvering* v. *Moloney Electric Co.* 120 Fed. (2d) 617 (C. C. A. 8); *C. C. Clark, Inc.* v. *United States,* 126 Fed. (2d) 292 (C. C. A. 5); *Nevada Massachusetts Co.* v. *Commissioner,* 128 Fed. (2d) 347 (C. C. A. 9). In all of these cases there was a clear cut distinction from the situation in the instant one. The said cases support the contention advanced by this petitioning taxpayer. The decisions in said cases are seemingly based on the very features which distinguish said cases from the instant one.

"The limited words of the Section (26 (c) (2)) were chosen deliberately and although they should not be read

in entire disregard of the background of the general purposes, they were certainly not intended to execute that purpose completely" (extract from Circuit Court's opinion in instant case). In these words the Circuit Court of Appeals recognized the validity of taxpayer's contention that the purpose of the Section 26 (c) (2) must have as important a part in allowing credits as the actual wording of the section.

Helvering v. *Northwest Steel Mills*, 311 U. S. 46 involved a deficit corporation of the State of Washington and was decided on the question that there was not a written contract restricting dividends as provided by Section 26 (c) (1); reference to Section 26 (c) (2) was merely on a comparative basis as to necessity of a "written contract".

Conclusion.

The question herein presented has not been passed on by this Court. The Circuit Courts have obviously reached different interpretations of Section 26 (c) (2). Credits to taxpayers on undistributed profits taxes are of such importance today as to call for review of the question herein presented. It is, therefore, respectfully submitted that this petition for Writ of Certiorari be granted.

GARONO, JAECKLE & KELLY,
Attorneys for Petitioner,
1524 Rand Building,
Buffalo, New York.

FRANK D. SCOTT,
Munsey Building,
Washington, D. C.,
Counsel for Petitioner.

CHARLES J. WICK,
1524 Rand Bldg.,
Buffalo, N. Y.
Counsel for Petitioner.

APPENDIX.

Revenue Act of 1936, c. 690, 49 Stat. 1648:

Sec. 14. Surtax on Undistributed Profits.

(a) *Definitions*—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

* * * * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) *Imposition of Tax*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

* * * * * * *

Sec. 26. Credits of Corporations.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * * * *

(c) *Contracts Restricting Payment of Dividends*—

(1) *Prohibition on Payment of Dividends*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) *Disposition of Profits of Taxable Year*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

* * * * * * *

Sec. 27. Corporation Credit for Dividends Paid.

(a) *Dividends Paid Credit in General*—For the purposes of this title, the dividends paid credit shall be the amount of dividends paid during the taxable year.

* * * * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

Art. 26-2. *Credit in connection with contracts restricting payment of dividends.*—(a) The credit provided in section 26 (c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c). The provisions recognized by the Act are of two general types as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

* * * * * * *

(c) *Disposition of profits of taxable year.*—Under the provisions of section 26 (c) (2), a corporation is allowed a credit in an amount equal to that portion of the earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred on or before April 30, 1936. The credit is limited to that amount which is actually so paid or irrevocably set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable

year shall be recognized as a basis for the credit provided in section 26 (c) (2). A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bond, (2) to maintain a sinking fund sufficient to retire all or a certain percentage of such bonds by maturity, (3) to pay into a sinking fund for the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal mined, or (4) to pay into a sinking fund for the retirement of such bonds an amount equal to a certain percentage of gross sales or gross income. Such provisions do not expressly deal with the disposition of earnings and profits of the taxable year. A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of "net income", "net earnings," or "net profits."

* * * * * * *

BRIEF FOR PETITIONER.

Statutes and Regulations Involved.

Sec. 26 (c)(2) Revenue Act of 1936, C. 690, 49 Stat. 1648, and Treasury Regulations 94 promulgated under the Revenue Act of 1936, Article 26 (c)(2) are set forth in the Appendix of Petition, pp. 9-11.

Statement.

Appears in Petition, pp. 2-5.

Question Presented.

Where a taxpayer corporation threatened with bankruptcy enters into a written contract with the trustee for its creditors requiring said taxpayer to pay to such trustee a stated amount upon the sale of each unit of its sole product and commodity sold by it during each week, is the contract so entered into one which "expressly deals with the disposition of earnings and profits of the taxable year" within the meaning of Section 26 (c)(2) of the Revenue Act of 1936?

Argument.

The question herein presented has never been passed on by this Court. Various Circuit Courts have come to conflicting conclusions as to the interpretation of Sec. 26 (c)(2). Credits on undistributed profits taxes are of sufficient importance to merit a review.

The only objection raised by the Commissioner to granting taxpayer credits authorized by Sec. 26 (c)(2) of the Revenue Act of 1936 is that the contract of taxpayer with the Trustee contains no provision which expressly deals with the disposition of earnings and profits. The 6th Circuit, in the case *Commissioner* v. *Michigan Silica Co.*, 124 Fed. (2nd) 397, had before it the question of a contract

requiring taxpayer to pay under a trust indenture twenty-five cents per ton of sand sold by it during each preceding month to a trustee, who was to deposit the money so paid in a sinking fund and at least once during the fiscal year to use the moneys for the redemption or purchase of taxpayer's outstanding bonds. Even though the trust indenture did not expressly use the terms earnings or profits, it was held in said case that the statute does not require that such terms be used, but only that the written contract contain a provision which expressly deals with the disposition of earnings and profits of the taxable year. The payments in this case, it is to be noted, were unit payments for each unit of sale. The 6th Circuit affirmed per curiam the decision of the Board of Tax Appeals recorded in 41 BTA 511, which held that the contract involved was one entitling taxpayer to a credit under Sec. 26 (c)(2).

The 3rd Circuit had before it in the case of *Clover Splint Coal Co.* v. *Commissioner,* 130 F. (2d) 52, the question of a contract arising out of a mortgage indenture which provided that the taxpayer was to pay a fixed sum for each ton of coal mined. The 3rd Circuit, while it decided against taxpayer and disallowed the credit under Sec. 26 (c)(2), indicated that its decision disallowing the credit was reached because there was no requirement that the coal mined be sold, and hence the payments were not directly tied in with the sales, earnings and profits of taxpayer. In that case also there was no proof offered that the taxpayer had no other source of income or profit.

In *Helvering* v. *Moloney Electric Company,* 120 F. (2d) 617, the 8th Circuit refused to allow a credit under Sec. 26 (c)(2) because the agreement requiring taxpayer to pay the trustee of its bond sinking fund on June 1st of each year "2% of the largest amount of bonds at any time outstanding" was not conditioned on the existence of earnings in that year. In other words, the payments required by the

contract could have been made from other earnings or accumulated profits of taxpayer and did not expressly deal with the disposition of earnings and profits of the taxable year.

Similarly, in *C. C. Clark, Inc.* v. *U. S.*, 126 F. (2d) 292, the 5th Circuit refused to allow deductions of payments required to be made out of the income of the corporation without regard to the sources. The 5th Circuit stated that the credit allowed by Sec. 26 (c)(2) may be taken only upon payments made during the taxable year from profits earned during the taxable year.

Nevada Massachusetts Co. v. *Commissioner*, 128 F. (2d) 347, involved a Maine corporation which had purchased assets of the bankrupt Pacific Tungsten Company. The Maine corporation was organized by the creditors of the Pacific Tungsten Company, and the agreement in that case recited that the taxpayer "out of the net proceeds of the operation of the said mining property of the said Pacific Tungsten Company * * * and out of any other money which the said corporation may have available * * * it will pay". The 9th Circuit felt that this contract did not expressly deal with the earnings and profits of the petitioning taxpayer as required by Sec. 26 (c)(2), but rather with the earnings and profits of the Pacific Tungsten Corporation, and it also felt that under the contract in question taxpayer could make its payments not only out of earnings and profits but out of other money which the corporation may have available.

In the instant case the record is clear that taxpayer was a bankrupt corporation and had no means of making payments except out of its sales earnings (R. 24); that it had one and only one source of earnings, viz.: the sale of its only product, beer; that profit, if any, to the corporation had to be realized out of the sale of this sole product, beer (R. 37); that it had agreed to make a unit payment on each unit of

sales (R. 24), and that the *unit of payment selected was the highest amount of profit possible on each unit of sale* (R. 19, R. 37). The payments of taxpayer were irrevocably made to the Trustee for taxpayer's creditors (R. 10 to 16). Taxpayer had to give monthly statements and quarterly audits, and the salaries of taxpayer's officers were specifically limited during the term of the agreement (R. 14 and 15).

Taxpayer therefore feels that under the interpretation placed on Sec. 26 (c)(2) by the Circuit Court in the 6th, 3rd, 8th, 5th and 9th Circuits, as indicated in the above mentioned cases, it would be entitled to the credits allowed by Sec. 26 (c)(2). Taxpayer further feels that the said interpretation is at variance with the interpretation placed on the said Section by the 2nd Circuit, which held in its opinion in this case that it must "look to the contract alone". In fact, it is respectfully submitted that this taxpayer under its contract had "no legal escape from making the payments out of earnings and profits". If this test, viz.: that taxpayer must have no legal escape from making payment out of earnings and profits, enunciated by the 2nd Circuit in its decision in the instant case had been followed, it is respectfuly submitted that the said court would have come to a contrary conclusion. *This taxpayer's unit payments were at the highest possible profit per unit of sales* (R. 19, R. 37).

There remains for consideration the case of *Helvering* v. *Northwest Steel Rolling Mills, Inc.*, 311 U. S. 46. This case involved a deficit corporation of the State of Washington. Under the statutes of the State of Washington, a deficit corporation could make no distribution of profits by dividends. The Northwest Steel Rolling Mills, Inc., claimed that its charter with the State of Washington constituted a contract, and that under that contract it could not under Washington law distribute profits by way of dividends, and

hence was entitled to a credit under Sec. 26 (c) (1). This case obviously did not involve any interpretation of credits to be allowed under Sec. 26 (c) (2) covering contracts which "expressly deal with the disposition of earnings and profits of the taxable year". The only reference in the *Northwest Steel Mills* case to Sec. 26 (c) (2) was one to the effect that since Sec. 26 (c) (2) required a "written contract executed by the corporation", it must be presumed that Congress intended that there be a similar type of written contract under Sec. 26 (c) (1).

It is respectfully submitted that the question herein presented has not been passed on by this Court; that there is obvious difference of opinion among the various Circuit Courts as to the interpretation of Sec. 26 (c) (2); that credits to taxpayers on undistributed profits tax are of such importance today as to call for a review of the question herein presented, especially since Congress in its last tax bill has made provision for credits to deficit corporations.

It is, therefore, requested that the petition for a writ of certiorari be granted.

Respectfully submitted,

GARONO, JAECKLE & KELLY,
Attorneys for Petitioner,
1524 Rand Building,
Buffalo, New York.

FRANK D. SCOTT,
Munsey Building,
Washington, D. C.,
Counsel for Petitioner.

CHARLES J. WICK,
1524 Rand Building,
Buffalo, N. Y.,
Counsel for Petitioner.

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In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 846

MAGNUS BECK BREWING COMPANY, INC., PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 23–27) is reported in 46 B. T. A. 78. The opinion of the Circuit Court of Appeals (R. 44–47) is reported in 132 F. (2d) 379.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on December 23, 1942 (R. 47–48). The petition for a writ of certiorari was filed on March 23, 1943. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial

Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether a contract requiring the taxpayer corporation to pay to a trustee for its creditors a stated amount upon each barrel of beer sold by it during each week, is a contract which "expressly deals with the disposition of earnings and profits of the taxable year" within the meaning of Section 26 (c) (2) of the Revenue Act of 1936.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved may be found in the Appendix, *infra,* pp. 7–9.

STATEMENT

Pursuant to a trust agreement dated January 31, 1934 (R. 10–17), the taxpayer, Magnus Beck Brewing Company, Inc., obligated itself to pay to a designated trustee "Fifty cents (50¢) per barrel on all beer sold during the months of April and May, 1934, and One Dollar ($1.00) per barrel on all beer sold thereafter." (R. 12–13.) The fund so created was to be paid to specified creditors in accordance with an agreed plan of priorities. (R. 14.) The trustee was given power to "waive" the prescribed payments "if he shall deem such waiver expedient and necessary." (R. 13.) In the event of a continued default the trustee was empowered to foreclose the mortgage which had been given as security for performance. (R. 13.) The taxpayer had an oral understand-

ing with the trustee that it should pay its indebtedness from earnings. (R. 25.)

In 1936, the tax year in question, the taxpayer sold 64,746.75 barrels of beer and paid $47,332.98 to the trustee. (R. 25.) In that year its profits totalled $60,415.96. (R. 26.)

In computing the surtax on undistributed profits imposed by the Revenue Act of 1936, the taxpayer claimed and the Commissioner of Internal Revenue denied a credit of $47,332.98 under Section 26 (c) (2). (R. 26.) The issue presented was whether the trust agreement in question contained a provision which "expressly deals with the disposition of earnings and profits of the taxable year" within the meaning of that section. The Board of Tax Appeals answered this question in the affirmative and, therefore, concluded that the contested deduction should have been allowed. (R. 27.) The Circuit Court of Appeals for the Second Circuit answered the question in the negative and reversed. (R. 47.)

ARGUMENT

The trust indenture did not expressly provide that the specified payments be made out of or be measured by the earnings and profits of the taxable year. Although the taxpayer's payments to the trustee in 1936 were made out of its 1936 earnings, this was not a legal requirement of the trust indenture. A contractual requirement of this nature is not one which "expressly deals with the

disposition of earnings and profits of the taxable year," as the statute (Section 26 (c) (2)) specifically requires. Cf. *Helvering* v. *Maloney Electric Co.*, 120 F. (2d) 617, 620 (C. C. A. 8), certiorari denied, 314 U. S. 682, rehearing denied, 315 U. S. 826; *C. C. Clark, Inc.* v. *United States*, 126 F. (2d) 292, 294 (C. C. A. 5); *Nevada-Massachusetts Co.* v. *Commissioner*, 128 F. (2d) 347 (C. C. A. 9); *Clover Splint Coal Co.* v. *Commissioner*, 130 F. (2d) 52 (C. C. A. 3); *Commissioner* v. *Saginaw & Manistee Lumber Co.* (C. C. A. 7), decided February 27, 1943 (1943 Prentice-Hall Federal Tax Service, par. 62,531). Accordingly, the court below, in accordance with the virtually unanimous court decisions, correctly rejected the contention, that the deduction was nevertheless available because as a practical matter the circumstances were such that the payments could only be made out of earnings and profits.

The only decision which looks the other way is *Commissioner* v. *Michigan Silica Co.*, 124 F. (2d) 397 (C. C. A. 6).[1] This decision has not been followed in the other circuit courts of appeals, and

[1] Petitioner contends (Pet. 6) that *Clover Splint Coal Co.* v. *Commissioner*, *supra*, likewise is contrary to the decision below. However, the explanation offered (Pet. 13) in support of this contention discloses that petitioner means only that the instant problem was not considered in that case and therefore may be an open one in the Third Circuit. The contention even thus qualified is of dubious merit.

would in all probability no longer be considered controlling in the Sixth Circuit. It was a memorandum decision which concluded by citing *Commissioner* v. *Strong Mfg. Co.,* 124 F. (2d) 360, decided the same day by that same court. The rationale of the two decisions is the same, namely that practical effect on the taxpayer rather than precise contractual language is the controlling test in applying Section 26 (c) (2). Since that rationale was rejected by this Court when the *Strong Mfg.* case, together with its companion cases,[2] was reversed (*Helvering* v. *Ohio Leather Co.,* 317 U. S. 102), the *Michigan Silica* case is probably no longer authoritative in the Sixth Circuit. This conclusion is fortified by the fact that this Court expressly pointed out (*Helvering* v. *Ohio Leather Co.,* 317 U. S. 102, 106–107) that one of the conditions precedent to the allowance of a credit under Section 26 (c) (2) is the existence of a contractual provision (absent both here and in the *Michigan Silica* case) expressly dealing with the disposition of earnings and profits.

The problem is not one of present importance[3] and in the absence of a clear existing conflict of decisions we believe that review by this Court is not warranted.

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[2] *Commissioner* v. *Ohio Leather Co.,* 124 F. (2d) 397; *Commissioner* v. *Warren Tool Corp.,* 124 F. (2d) 397.

[3] It arises only under the Revenue Act of 1936. Cf. Section 27 (a) (4) of the Revenue Act of 1938; Section 27 (a) (4) of the Internal Revenue Code.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

CHARLES FAHY,
Solicitor General.
SAMUEL O. CLARK, JR.
Assistant Attorney General.
SEWALL KEY,
SAMUEL H. LEVY,
EDWARD FIRST,
Special Assistants to the Attorney General.
VALENTINE BROOKES,
Attorney.

APRIL 1943.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—

* * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

* * * * *

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(c) *Contracts Restricting Payment of Dividends.*—

* * * * *

(2) *Disposition of Profits of Taxable Year.*—An amount equal to the portion of

the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits.

* * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 26–2. *Credit in connection with contracts restricting payment of dividends.*— (a) * * * The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

* * * * *

(c) *Disposition of profits of taxable year.*—Under the provisions of section 26 (c) (2), a corporation is allowed a credit in an amount equal to that portion of the

earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred on or before April 30, 1936. The credit is limited to that amount which is actually so paid or irrevocably set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section 26 (c) (2). A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bonds, (2) to maintain a sinking fund sufficient to retire all or a certain percentage of such bonds by maturity, (3) to pay into a sinking fund for the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal mined, or (4) to pay into a sinking fund for the retirement of such bonds an amount equal to a certain percentage of gross sales or gross income. Such provisions do not expressly deal with the disposition of earnings and profits of the taxable year. A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of "net income," "net earnings," or "net profits."

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